Notre Dame Law Review

Volume 48 | Issue 3 Article 3

2-1-1973

Venture Captial Financing - Legal and Financial Considerations

Robert G. Cronson

VENTURE CAPITAL FINANCING—LEGAL AND FINANCIAL CONSIDERATIONS

*Robert G. Cronson**

I. The Venture Capital Situation

A venture capital situation ordinarily involves a company, a venture, an idea or a prospect which is not "bankable." Many business ventures, whether proprietorship, partnership, corporation or trust, have arrived at a stage of development where they are "bankable." They can obtain financing through some agency of commercial finance, such as banks, factors, public offerings, etc. Commercial financing is ordinarily available to an enterprise with a performance record which demonstrates earnings or assets sufficient to justify a commercial loan and give reasonable assurance of repayment.

There are, of course, many enterprises which also have a history of activity which will *not* justify commercial financing. This does not mean they are candidates for venture capital financing, but means they are destined to become part of the statistics on business failures.

Venture capital is the source of financing for those business ventures which have not *yet* reached the stage of being "bankable."

Venture capital situations break down basically into three categories. The first is the "concept situation," which is a shorthand description of a man with a bright idea and some discernible opportunity of success in promoting the idea. When Wilbur and Orville Wright conceived the idea of powered flight they were involved in a concept situation. Obviously, no commercial lender would have given them much. Thus, the funds for the development of the idea, the construction of the prototype, purchase of the equipment and operating costs would have been venture capital.

At a slightly further stage of development we encounter the "start-up." This is advanced somewhat beyond the concept situation. The promoters have reduced the concept to some specifics involving "X" number of square feet for available production, manufacturing, etc.; have worked out some estimates of raw material and production costs; have some estimates of operating capital, such as salaries, rent, interest costs, etc., that will be required and have entered upon some level of business activity which cannot be further expanded without additional funds. At some point Henry Ford was involved in a start-up situation in which he may have had the ability to assemble by hand and distribute a limited number of automobiles in a given period of time, and may even have been able to finance the limited operation. However, to get from there through the intermediate stages of planning and development and into mass production and dis-

* Senior Vice President & Secretary, The Chicago Corporation; B.A. 1947 Dartmouth, J.D. 1950 University of Chicago.

tribution required him to go through some start-up phase in which necessary funds would be available. It is interesting to note, parenthetically, that Henry Ford did sell a limited number of shares of stock in the Ford Motor Company at its very early stages to persons who were providers of venture capital in the purest sense and who profited handsomely from the courage of their conviction.

More advanced than either of these two situations, but still not at the stage of "bankability" is the infant company which is, in fact, in business on some basis, is manufacturing, producing or distributing services, or is otherwise engaged in business activity which is revenue producing but not necessarily profitable. However, neither the company's earnings capability nor its assets, nor its record of performance have yet reached a point which would justify commercial financing. At this point in its development any such company probably has recourse only to venture capital sources for funds necessary to achieve the future growth and development necessary to make it successful.

These categories cover every conceivable type of situation, from the neighborhood restaurant to a large manufacturing enterprise. In some cases the venture capital, as in the case of the neighborhood restaurant, may be provided by the promoter-proprietor, or by himself, his family and friends, or in the other case, it may be a combination of sources, even including Federal funding opportunities.

Anyone attempting to "structure" a venture capital deal must bear in mind certain inescapable economic facts of life about the conventional venture capital deal.

1. Because it is either a concept, start-up, or infant company, the prospects of success are difficult to discern and the risks are correspondingly high.

2. The percentages of success and failure add an additional risk in a competitive economy. There are certain variables which are beyond control. Regardless of the competence of the promoter, the desirability of the idea, the soundness of the planning, or any other factor which addresses itself to ultimate success or failure, a substantial number of new and infant ventures inevitably fail in the market place. Accordingly, any given venture capital situation is subject to an indeterminate percentage factor which assures that some substantial portion of enterprises which are financed through venture capital will fail. As a necessary corollary, any reasonably sophisticated source of venture capital must be assured of a substantial profit potential as an offset to the prospects of failure. In oversimplified terms, the venture capital investor must be assured a sufficient opportunity of profit to compensate for the risk of loss.

3. Every venture capital situation necessarily involves an incubation period which varies from intermediate to long. Certainly, anyone who advanced money to Wilbur and Orville Wright could not have seriously contemplated that the design, manufacture, testing and distribution of

such a novel concept as the airplane could be accomplished in anything less than a period of several years. Because the return to the investor can come only at the end of the incubation period he must look forward to a relatively long waiting period during which his money is at risk in an unknown venture with a high risk of failure.

4. Through this long period venture capital will not only be committed to the enterprise, but will in all probability return little, if any, yield to the investor. The "yield" will come only when the venture capital situation has passed through its infancy and incubation and arrived at a point in time and development where it is sufficiently successful to provide a vehicle to compensate the investor.

II. The Venture Capital Financing Structure

How do you make such a situation attractive to a potential investor? It is necessary to present a *reasonable* opportunity to double or perhaps triple his money. In the current market place AAA corporate bonds may be purchased to yield 7½ to 8¼ per cent. Such an investment gives reasonable assurance of the preservation of an investor's principal, plus a return on capital of something in the nature of 40% over and above the principal over a five-year period. This being the case, a venture capital situation must offer, as an incentive, an opportunity to substantially increase the available return as compared to this type of relatively low risk investment opportunity. If such investment opportunities in high grade corporate bonds are available at a 140 per cent return over five years, any reasonably astute investor would be silly to risk his money in a venture capital situation for 160 or 170 per cent over the same period of time. Unless and until we arrive at a 200 per cent or better figure, the venture capital situation obviously will not attract his interest. These comparisons will vary somewhat depending upon the existing yield structure in the market place, tax considerations affecting capital gains against ordinary income, and a number of other factors not directly related to the facts of the venture capital situation. Any such additional developments obviously have to be taken into account in determining the structure of the venture capital situation.

Assume a hypothetical situation in which Mr. X, a potential source of venture capital, is asked to provide $500,000 for a pure concept situation. The promoters have developed a viable concept, have done their homework carefully, have had the benefit of adequate accounting assistance in determining cost and revenue projections, and have experience which gives reasonable assurance of success in the venture. The promoters can project that at the end of a five-year period their venture capital situation will have successfully resulted in the manufacture and sale of some product or service which will yield a net return, after taxes, of $600,000. It is possible to project some realistic values for such an enterprise in the market place.

Research of the industry in question and similar industries, will indicate that the earnings of such companies will be valued in the market place by a "times earnings" factor. If we estimate that the enterprise which produces $600,000 net after taxes will be valued at a times earnings factor of twelve, we can conservatively reduce that times earnings factor to a figure of ten and apply it to these earnings. The net earnings of $600,000 multiplied by a figure of ten will yield a value of the enterprise of $6,000,000. If the investor is unwilling to provide funds without a reasonable expectation of doubling his money, it will be necessary to insure him of the right to receive 16 2/3% of the enterprise at the end of five years. If the enterprise will be worth $6,000,000 at the end of five years, the investor who has invested a half million dollars will have an investment worth $1,000,000 if he owns 1/6 (16 2/3%) of the resulting enterprise. If, on the other hand, the estimates and projections indicate an enterprise will earn $300,000 net after taxes at the same times earnings factor, it will be necessary to provide 33 1/3% to the investor in order to bring him out with the same $1,000,000.

To further illustrate, if we assume the same enterprise will earn $100,000 after taxes at the end of the five-year period it will be necessary to give the investor 100% of the equity to attract his venture capital funds ($100,000 x 10 = $1,000,000). Obviously, this is impossible. There is a point beyond which it is impossible to offer a "piece of the action" because that which is offered makes it clear that the incentive which is essential to the investor destroys the promoter's incentive. No one devotes five years of time and effort to create an enterprise which will be 100% owned by someone else. This is true at 90, 80, and 70 and perhaps even 60%. From this percentage point down lies the realm of possibility from the point of view of the promoter and investor.

What, then, is the vehicle through which the investor will, in fact, realize dollars from his ownership of a portion of the equity ownership of the enterprise? In most cases the ability to realize on his investment will involve the investor taking his profit in the form of the proceeds of sale of equity securities in a public offering of such securities. It is not realistic to expect the enterprise to prosper and generate the necessary earnings, and simultaneously generate excess funds with which to pay off the investor without impairment of operating capital. Thus, the payoff to the investor can come only by the sale of the investor's ownership to the investing public. In this manner the investor realizes his profit, the company realizes its success, the enterprise retains necessary operating capital and the promoters reach a point of opportunity to share in the success.

Accordingly, when arranging a venture capital type of financing, an "out" must be provided at the end of the development period. While there is no magic formula requiring this to be a public offering of securities, it is in most cases the most attractive method. Various other combinations can, of course, be contemplated. Thus for example, there can be a mutual buy-and-sell agreement in which the promoter enters into an agreement now to buy out the investor at some predetermined figure at the end of five years. If the enterprise succeeds and reaches the goals described in its projections the promoters may then find themselves in a position, personally, to be able to finance the acquisition from the investor, using valuable collateral which the equity owners will then own. In most cases, however, such arrangements, of whatever kind, will be less desirable from the investor's point of view than the opportunity for public distribution of some or all of his ownership.

Because the ultimate public offering is such an integral part of the ordinary structure of venture capital financing, it is necessary to have some understanding of the basic requirements of a public offering. It is important to bear in mind that the investment banking industry in America is a large and aggressive industry and that with sufficient tenacity one can probably find an underwriter to underwrite almost any kind of venture at any state of development and under almost any market condition. However, there are some broad standards of eligibility for a public offering, particularly if these apply to an initial public distribution.

In the ordinary circumstance underwriters are reluctant to underwrite an initial public offering in which more than 40% of the outstanding stock is to be sold to the public and, in fact, prefer a lesser percentage. Investors in a new issue prefer to see selling shareholders continue to be committed to the future growth and development of the company. For purposes of this illustration, however, let us assume that 40% of the stock will be sold on the initial public offering.

This 40% should be represented by a minimum number of shares in order to provide sufficient depth and liquidity to provide for an orderly after-market when the initial public distribution has been completed. This should be approximately 200,000 shares. The price should be at a level which will attract investors to purchase in round lots. However, it should not be at a price which is so low as to indicate that the offering is highly speculative in nature. This will indicate a price somewhere in the $10 area. These factors, considered together, require an offering of $2,000,000 (200,000 x $10) which represents 40% of an entity which must necessarily, therefore, have a value of $5,000,000 ($5,000,000 x 40% equals $2,000,000). To again return to the times earnings factor previously discussed, this $5,000,000 product indicates a requirement that the company earn approximately $400,000 net after taxes, assuming that a reasonable times earnings factor is 12½. Obviously, all of these variables can alter the circumstances in an individual case. However, for present purposes, the example illustrates the approximate operating level which must be attained before the company which has been the subject of venture capital financing can be brought to a position from which the venture capital investor can reasonably see an opportunity to recoup on his investment.

Notwithstanding that these recovery methods are all addressed to the sale of equity ownership, the conventional venture capital financing is a debt arrangement and varies between two standard formulae. The investor receives either convertible debentures, or some similar debt instrument which is convertible into the amount of common stock which is the subject of the agreement, or receives a debt instrument, together with an option to acquire common stock in a specified amount with the requirement that the debt instrument be surrendered in exercising the option. This type of structure is ordinarily used to insure that the venture capital investor is assured of some priority as against equity owners (promoters) during the incubation period of the company's development and to afford the maximum possible protection in terms of the investor's ability to recover in the event of unsuccessful operation.

III. Sources of Venture Capital Funds

There are a number of potential sources of funds for any capital venture situation[1]—again depending upon the type of situation, the size, the promoter involved, the prospects of success, the proper incentive and other facts which must be considered. There are a number of professional capital venture sources. These are companies which have a pool of available capital which is used to invest in venture capital situations. Such institutional funds do nothing but search out venture capital opportunities, carefully evaluate them and select those which present the maximum opportunity for success and reward. There are such institutional funds in metropolitan areas throughout the United States. Some of them have investment policies or peculiarities. At any given time, a venture capital source may think particular industries do not look promising. At such a time you may find yourself involved in an effort to find venture capital funds for a merchandising company when the particular fund is "not doing merchandising deals this year."

Similarily, you may find that the individual institutional fund does not like "mortgage deals." There is no handy reference or source material which will direct you to the institutional venture capital funds, or give you a clue as to their policies or predilections. In many cases it will be necessary to employ the services of an intermediary such as a banking institution, an investment banker, a consultant, or some other agency or individual who specializes in finding such sources of venture capital.

Such intermediaries are in continuing contact with the market place and with the venture capital investors. As a result, they are aware of policies and predilections, and can often save the time which would otherwise be wasted in learning them.

In addition to the institutional venture capital investor, there are individuals who are willing to consider venture capital investments. These are ordinarily affluent individuals of considerable personal sophistication and expertise who are seeking not only high profit situations, but tax considerations as well. Again, it may be necessary to use the services of an intermediary to search out such individuals.

In recent years there has been a growing tendency for the commercial banks to enter into various kinds of arrangements to provide venture capital for business enterprises which the banks cannot finance through their own sources. The growth of bank holding companies has permitted the establishment of operating subsidiaries, separate from the bank, which operate as an institutional venture capital source. This not only makes investments available to the bank holding company, but also hopefully creates a source of future conventional commercial financing business for the bank when the venture capital situation has progressed to a point of being bankable. In some cases in which a venture capital situation has particular appeal in a given industry it may be possible to find a large business enterprise in that industry which will be willing to invest in a venture capital

1 "Friends and neighbors" are always a source of venture capital. However, the procedures to be followed with such investors take on highly personal characteristics.

situation in the hope of developing a product or service which will be useful to the investing company at the same time that it yields a substantial profit from the development.

All venture capital financings are essentially "private placements" as that word is used in both the legal and financial community. This is only to say that they involve the sale of securities in "transactions by an issuer not involving any public offering."[2] Although the term private placement is used on a wholesale basis by the legal fraternity, the investment banking industry and the SEC, it is, in fact, a term which does not appear in the Federal Securities Act, nor for that matter in any securities legislation, state or federal. Rather, it is a concept which has developed over the years and is used as a shorthand term of description. "Private placement" is the sale of securities which are not registered under applicable federal statutes and in most cases under applicable state laws, but rather sold in "transactions not involving any public offering" to persons and under circumstances which render unnecessary compliance with applicable registration requirements. Some further comments on the private placement situation are offered in the caveats at the end of this article.

The term "private placement" also carries another meaning in conventional investment banking terms. In this case the investment banker or other intermediary attempts to arrange the placement of securities with one or a limited number of sophisticated investors who in fact pool their funds and obtain a proportionate part of the venture capital situation. With a well-defined venture capital opportunity it is possible to enlist the services of intermediaries in placing such situations. Just as the one bank holding company is interested in developing the venture capital situation into a future commercial banking customer, so the investment banker is interested in developing the venture capital situation into an ultimate public offering customer.

IV. Caveats of Venture Capital Financing

The whole thrust of obtaining venture capital funds revolves around the projection. The investor's determination of the amount of equity ownership (piece of the action) which he requires is based on the projected earnings. Likewise, the investor's return of his capital investment and profit is related to the projected earnings. The investor profit built into the structure is a function of the enterprise's achieving the results projected. But beyond that, the investor's assurance of the viability of the enterprise and the ability to ultimately recover anything, even his investment, is a function of the enterprise's achievement of something approaching the projected level of activity. If a venture has been projected to generate $100,000 of earnings in its third year of operation and, in fact, generates only $60,000, the investor begins to see the dissolution of not only his profit in the enterprise, but also the approach of the risk of total failure because the company has not performed in the manner in which it was represented. When a company's actual performance deviates appreciably from the original projections, which were the basis of the investor's decision to invest, it always creates a

2 Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970).

nervous and unhappy investor who immediately begins to inquire after the safety of his investment and the prospects of success. On occasion his "interference" may, in fact, turn out to be assistance and may serve a beneficial purpose for the enterprise. However, both from the promoter's and investor's point of view, it is a much happier situation if the investor is not obligated to take a hand in the management and development of the enterprise and the promoters are left free to pursue their own plan of development. In short, to insure the happiest result for all concerned, it is always highly desirable to "hit the projection." The sophisticated venture capital investor will maintain some continuing supervision of the enterprise, probably to insure that it is continuing to perform in accordance with the projections which formed the basis for his favorable investment decision. As long as it "hits the projection" all is well. Accordingly, it is essential not only to "hit the projection" but to be extremely careful in preparing the projection to insure that it projects a goal which is reasonably capable of being accomplished. The preparation of an unrealistic projection designed solely to attract the interest of the investor will inevitably lead to serious repercussions as operating experience falls short of the projection and, therefore, the investor's reasonable expectation.

An additional caveat results from a recent decision coming out of the Circuit Court of Appeals for the 5th Circuit in *SEC v. Continental Tobacco of South Carolina.*[3]

In this case the SEC addressed itself to the existence of the "private placement" exemption under the Federal Securities Law. For many years the rationale which is generally described as the *Cady-Roberts*[4] line has been adhered to and accepted by the courts. The *Cady-Roberts* line holds that a security need not be registered under the Federal Securities Act if the persons to whom the securities are sold are limited in number and if such persons are provided with complete and adequate disclosure of all material information concerning the offering company and the securities offered so as to receive the same information which they *would* have received had the offering been registered under the appropriate disclosure requirements of the '33 Act. In the *Continental Tobacco* case[5] the SEC has asserted in its brief an argument that each offeree in a private offering must have a relationship to the company that is tantamount to being an insider in terms of his ability to know, understand and verify for himself all of the relevant facts about the company and the securities. At this time it is impossible to say whether this SEC interpretation will be accepted by the courts or adopted into the case law dealing with the requirements of a valid private offering. However, until the matter is clarified in the courts it will be necessary to exercise great caution in arranging "private placements" while this threat of invalidity is hanging over the field.[6]

The last of the caveats is that while any venture capital deal must be care-

3 No. 71-2955 (5th Cir. June 2, 1972); CCH [current volume] FED. SEQ. L. REP. ¶ 93,507 (1972).

4 Cady, Roberts & Co., 40 SEC Dec. & Rep. 907 (1961).

5 SEC v. Continental Tobacco, No. 71-2955 (5th Cir. June 2, 1972); CCH [current volume] FED. SEC. L. REP. ¶ 93,507 (1972).

6 *See* Henderson v. Hayden, Stone Inc., No. 71-2971 (5th Cir. June 2, 1972); CCH, [current volume] FED. SEC. L. REP. ¶ 93,504 (1972).

fully structured in such manner as to enlist the interest of the investor and assure him a "reasonable" return in the long run, it must still maintain enough flexibility to allow for adjustments to the individual requirements and peculiarities of an intermediary who may assist in the placement as well as the ultimate investor who reaches a favorable investment decision. For example, a well-structured deal which offered 30% of the equity, no more and no less, could very well fail to enlist the interest of an investor who found the entire proposal attractive but who felt that *any* venture capital situation should reasonably yield a 33 1/3% ownership interest to the venture capital investor.

V. Conclusion

In check-list form the following is a reasonable step-by-stey procedure to be followed in preparing a venture capital situation for submission to a potential investor.

1. Determine to the best of your ability that the investment situation is genuinely a venture capital situation. If it is definitely bankable or simply a sick company which is not eligible for financing assistance don't waste the time involved in preparing it for submission.

2. Be sure to do your homework adequately to prepare a proposed structure for the enterprise which will make it attractive to the sources of venture capital, realistic from the point of view of the promoters and soundly conceived so as to insure a reasonable opportunity for profit for all involved.

3. Structure your venture capital situation in such a way as to provide an "out" for the venture capital investor at a reasonable point of time.

4. Attempt to identify the available sources of venture capital which will be interested in your particular kind of enterprise.

5. Beware of the securities laws implications, both federal and state, of the sale of securities which are not registered under the applicable securities laws provisions.